DOW THEORY LETTERS INC.

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January 7, 1976 Letter 652

NEW YEAR THOUGHTS: I had to laugh when I read this piece by the great Will Rogers, written on the last day of 1929 and just before America was to go into its Economic Baptism of Fire. Times have changed, at least in some ways. Rogers' poor didn't have many rights, but today the rights of the "poor" (particularly the economic rights and handouts) are spread so thick and wide that I wonder if the "right to predict" shouldn't be given back to the rich again. At any rate, I often wish that Will Rogers were writing today. His wry (and very acute) observations may not have changed the world but they sure made it laugh at itself.

* * * * *

When I was in combat during World War II, we were told the story about the guy who killed himself because he couldn't stand the anxiety of not knowing whether he was going to live or die. Nothing strains the human psyche more than uncertainty, not knowing if, when or how.

Yet some men seem to thrive (neurotically, of course) on this kind of uncertainty and anxiety. It is said that the gambler is really asking the question, "Does mother love me or doesn't she?" He is asking this each time he throws the dice or sits down to a game of black jack. "If I win, that proves mother loves me" is the unconscious thought, and "if I lose she doesn't love me." But then he adds, "There's always tomorrow, and maybe tomorrow I'll be loved." Let it be noted that Luck is always a lady (mother), never a man. So the gambler turns his anxiety into a never-ending "she loves me — she loves me not" game. Men who feel secure about their inherent "loveability" are seldome interested in gambling.

The stock market can be made to perform the same function as a game of dice or cards, if that's what you are looking for. The difference between gambling and speculation is that gambling implies little or no knowledge or skill, just a throw of the dice. But the speculator applies his knowledge, artistry and skill to the situation. A speculator will never bet on the flip of a coin. In contrast to both, the investor is interested in values, and he seeks to eliminate gambling and even speculation from his activities. It has often been said, however, that a good speculation will often turn into an investment (for instance, a man speculates on a promising new company that later becomes a junior blue chip).

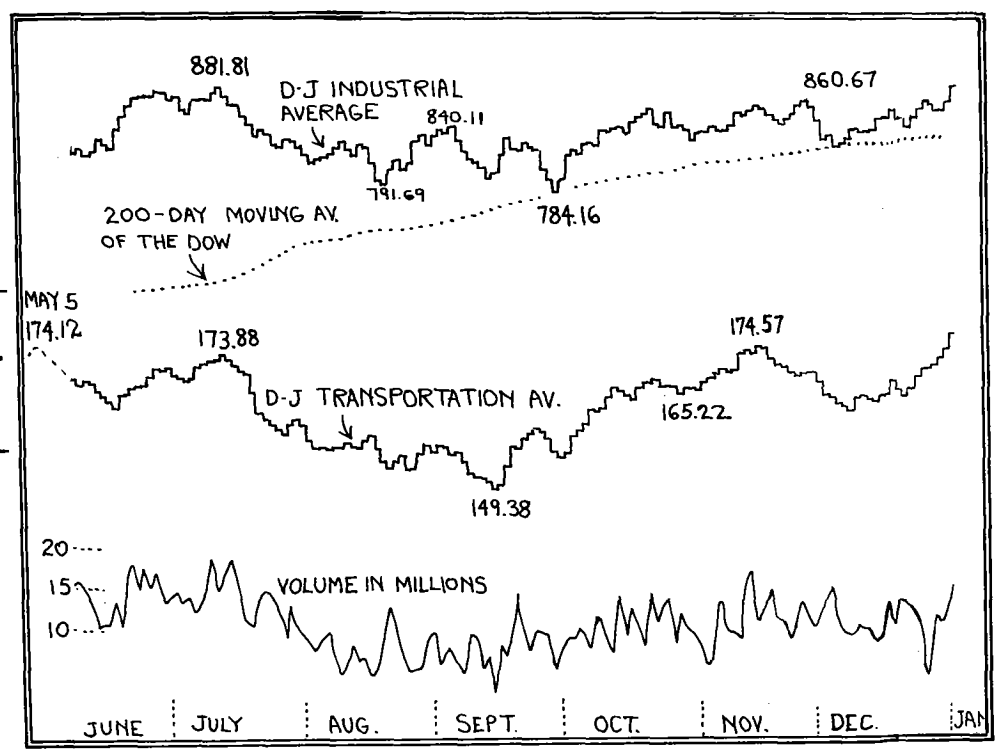
This is our last day grace. Tomorrow we are obliged to read the usual New Year's prosperity applesauce, by our same prominent men, who are always rich enough to see a great year coming up. And to show you they don't know any more than Clara Bow, last year they had their usual hokum predictions, and we lost half as much as it cost to put on the war. And yet not a one of these predicted it.

So, just for a change, let's let every man do his own predicting according to his own convictions and viewpoint. The poor haven't many rights as it is, so let's at least let 'em predict, especially as that's all they are going to get. — Dec. 30, 1929

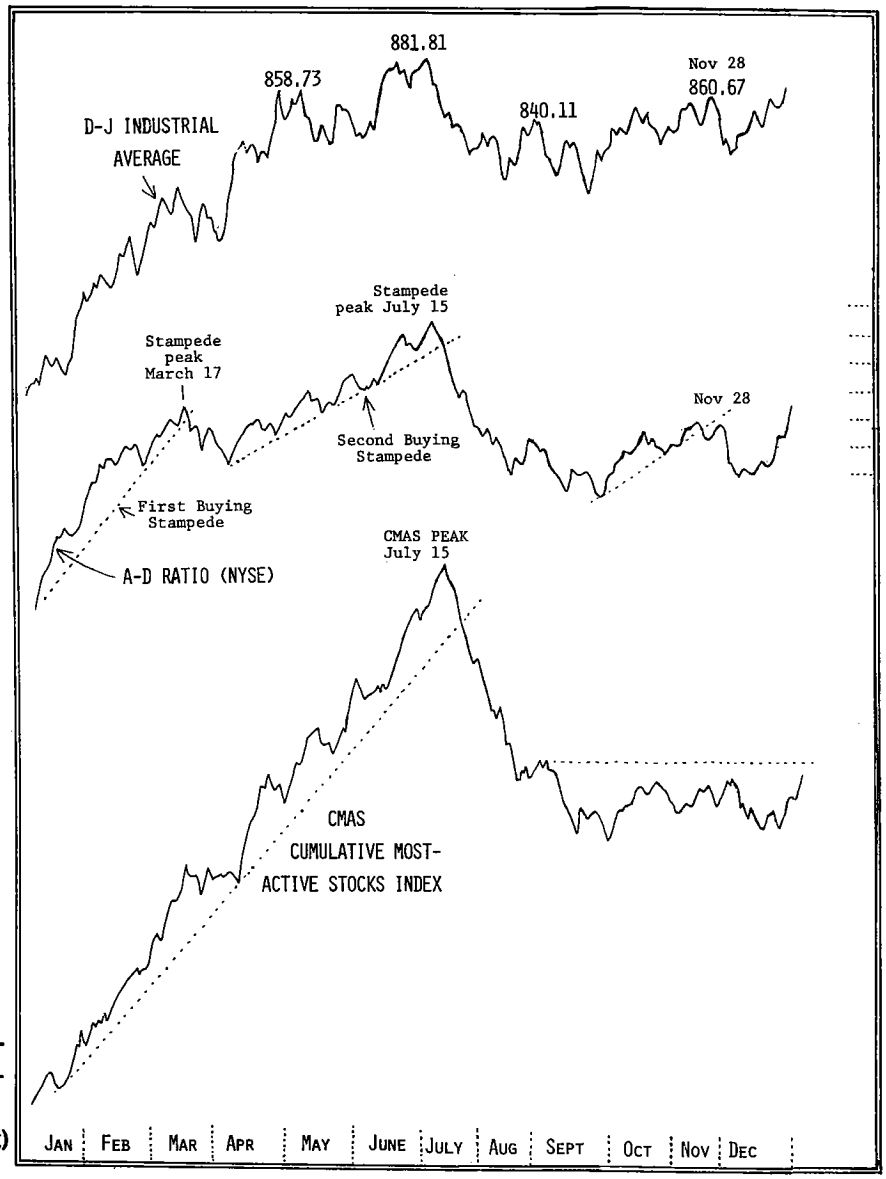
Some veteran traders live by the old adage, "When in doubt, get out." This is a particularly useful course of action following an extended advance in a bull market or at any time when the market is not doing "what it is supposed to do."

This bull market has been a winner at keeping us all uncertain, on edge and guessing. Since May, and more strikingly since July, the market has taken turns crossing up first the bulls, then the bears. Following the initial "buying stampede" of December to May, it seemed clear that the market was heading for trouble—but the trouble never materialized. A second buying stampede (see page 2 chart) got underway, carrying into mid-July. Past history suggests that buying stampedes come in series of three's, but the third stampede never got underway.

As of this writing, the 881.81 (July 14) peak stands as the high for the Dow in this bull market. The 175.69 Transport



peak (January 2) stands as the highwater mark for the carriers, as does the 87.03 (June 24) peak for Utilities. The July 15 peak on the A-D ratio represents the recovery high for breadth (and for many individual stocks). The percentage of weekly new highs topped out at 18.5% (of all stocks traded) during the week of June 30, and this was documented in the last report. On a daily basis, the 393 new highs of March 17 stands as the peak day for new highs in the bull market.



Following the mid-July advance, the market finally ran into recognizable trouble. From its July 15 peak, the A-D ratio broke 6.57 points to its October 1 low. I wrote at the time that (based on past history) when the A-D ratio, following an important advance, loses over 5 points, the prognosis is not good for the market. By "not good" I mean that new highs, following a 5 point break in the A-D ratio, are usually not seen for at least four to six months or even longer. With almost six months having passed now since the July 15 A-D peak, neither the Dow, the A-D ratio nor the majority of stocks have bettered their mid-July highs.

Note on the chart at right that the CMAS line, which is actually an advance-decline index of the most-active stocks, has also failed to keep up with the Dow. In fact, not only is CMAS far below its mid-July peak, but it still is under the late-August high (that high has been designated by the horizontal dotted line). I have always considered CMAS to be the index which shows the advancing or declining tendencies of "big money," and the conclusion here (at least up to this writing) is that big money moved to the exits during the July-October period. Since then the big money has been cautious, refusing to take a definite stand on either the buy or sell side. In due time, the big boys will move. When they do, they'll probably set the direction which the market will follow.

Despite all the hesitancy, despite all the technical problems, it is well to remember that the primary trend of the stock market is bullish, and credence must always be given to the direction of the all-powerful primary trend. The bullish designation of the primary trend implies that it is not a question of whether the Averages and the A-D ratio will eventually climb over the 1975 highs, it is simply a question of when — and how much correction may come first.

Following the September-October reaction lows, the market marched valiantly and persistently towards the 1975 highs again. On November 17 (see page 1 chart), Transports rallied to close at a new 1975 recovery high of 174.57. Industrials closed on the same day at 856.16. This meant that Transports had advanced to a new unconfirmed high (a confirmation would have entailed an Industrial bettering of their own 1975 recovery peak of 881.81). Next, a minor decline took place, following which the Averages rallied. But on the late-November rally Transports went flat, even though the Industrial Average pushed above its November 17 peak to close at 860.57. This constituted a second non-confirmation, producing what I termed a "double non-confirmation." Such structures in the past have almost always implied a strong reversal of the prevailing trend, and the market's first reaction ran true to form (see page 1 chart).

In the space of six trading days Industrials dropped 42 points to close at 818.80 (December 5), while Transports closed at 162.53 on December 9. The double non-confirmation had come during December, the month with the strongest seasonal bias (on the upside), and it remains to be seen whether this double non-confirmation will work out the way so many of its predecessors have.

LATEST PRICE MOVEMENTS: On Monday, January 5, the market surged forward again with breadth outstandingly strong. As this is written, it appears that Industrials will finally close above their secondary peak of 860.67, recorded on November 28. If this occurs, then a stumbling block which has bothered this market all during December will finally be removed. If 860.67 is hurdled, the main technical problem for this bull market will again come to the fore. That problem is whether the two Averages will signal a bullish "all clear" by rising into new recovery high ground together.

The July 14 high of 881.81 for Industrials stands as the chief target for the bull. A big push by the senior Average through the 881.81 point with Transports moving in the same direction (to new recovery highs) would serve as a bullish "convincer" to many market students (including this one) that the signs of danger have passed. On the other hand, a stubborn refusal by Industrials to better their July 14 (881.81) high would heighten the importance of the current non-confirmation. Remember, not since May, 1975, have the two Averages moved to bull market recovery highs together.

To review a little recent history, after the May highs in the Averages, Industrials pushed to a July 14 high of 881.81 (unconfirmed by Transports). That non-confirmation produced a five-month reaction. In October (see page 1 chart) the market turned up again, and on November 17 Transports rushed to a new recovery high (unconfirmed by Industrials). A rather mild decline followed.

On January 2 the Transport climbed to another recovery high, and a day later (January 5) it appeared that Industrials would oblige by bettering their secondary peak of 860.67. So again we are at the juncture where the market is put to the test. We should shortly find out whether the latest non-confirmation (i.e., new Transport high without new Industrial high) will lead to further correction — or whether this time the long-awaited "all clear" signal (i.e., both Averages rallying to new recovery highs) will be given.

CONCLUSIONS AND THOUGHTS FOR 1976: Nothing looks more enticing than a rising market that is days or weeks from topping out. Nothing looks more frightening than a market which has been falling and is a day or two from its final bottom.

One of the most frustrating of all market phenomena is the so-called "trading range." People love a bull move, they are often fascinated by a bear move, but nobody loves a long, tedious sideways trading range. During the entire second half of 1975, Wall Street was locked into a trading range which can best be seen in the action of the A-D ratio in its rise to the July 15 high, its decline to the October 1 low, and its subsequent climb back into the no-man's land between the July and the October points.

Since mid-July the market has embarked on no less than six trips into the middle 800's, and none of those forays has brought in the kind of buying capable of moving the Dow above its 881.81 upper trading range limits. In other words, the market has been stuck for the past six months.

The question I ask myself is this" "Will the current rally be different? Will this one be the one that injects adrenalin into the bull's blood, and will this rally finally break the technical impasse, moving the Average and indicators to new recovery highs?"

Frankly, I am dubious, but then I never argue with Wall Street's final verdict. However, I do prefer to wait and let the market show me if and how I am wrong. This is what I see for the bull side of the ledger during the current advance: (1) The Transports and Utilities have been leading the Dow, which is fine. Of course, we also have another non-confirmation in that Transports are currently at a new bull market recovery high, but Industrials have not yet bettered 881.81. (2) Negative volume is looking better now than it has in months. (3) Bonds, so far, have been rallying and therefore supporting the market. (4) The most-actives indices are moving up in direction, although CMAS (cumulative most-active index) has not yet neared its July peak. (5) The primary trend of the market, being bullish, places the time factor in the bulls' favor. The longer the elapsed time during a bull market correction, the nearer we are to the next primary upswing.

What bothers me here is that with the Transports at new recovery highs, the Industrials are still 20 points below their comparable 881.81 peak. Furthermore, so many of the technical indicators are now so far below their 1975 recovery highs that a continuation of the rally from here would appear literally to guarantee a long string of non-confirmations in the various indices that I use (for instance, the PTI, the A-D ratio, the CMAS, the weekly new highs). Furthermore, with the market currently quite overbought, any upward surge from this area is likely to produce "toppy" action in the market, with strength ebbing in such indices as the A-D ratio and CMAS.

All of which brings me to this conclusion: I am not impressed with the risk-reward equation for the buyer or the stockholder if the market should decide to continue its advance from here. True, many of the technical indicators could push on to form new secondary tops from here (i.e., new tops below their July, 1975 recovery tops), and we might have an advance which could take the Dow into the low 900's. But markets that "straighten themselves out" and push higher, after the yellow caution flags have been flying, have always bothered me. My experience with this kind of market suggests that the ultimate "good action" too often turns into a trap, and I end up by being sorry that I ever told anyone to "play" the move.

THOSE VERY ODD LOTS: When studying my data, there are two phenomena which I always watch for: (1) a new all-time record on an indicator, or (2) a very persistent trend in the Averages or in a given indicator.

The action of the odd lot statistics fits into both of these catagories. For purposes of illustration, I am turning to this chart put out by the Drew Odd Lot Studies and its very capable Editor, Bill Bretz (1915 N.E. 45th St., Ft. Lauderdale FL 33308). What we see here is a three-month moving average of the monthly average odd lot buy-sell ratios.

Most investors do not understand the basic concept of the odd lot studies, but what is important to comprehend is that the odd lotters tend to be wrong on the market at important turning points. In other words, contrary to popular opinion, the odd lot public may be correct in their buying or selling for months or even years on end, but they also tend to be incorrect at the turns.

Note on the chart that selling peaks such as the peaks of 1968, 1971, 1972 and 1973 corresponded with important tops in the market. But where the odd lotters went wrong was in reducing their selling (or moving towards buying) at the turn, and as the mar-

 ket headed down.

The dramatic fact about the current situation and the reason I have included the odd lot study in this report is that the three-month moving average (of the monthly odd lot figures) is now at 207, its highest level in 56 years! As I stated in a recent report, there is literally nothing for the odd lotter to do from here but sell less (since the current selling ratios are so astronomically on the sell side).

If, during the new year, the market starts down and odd lotters pull back on their selling (i.e., move towards the buy side) we could have a nasty slide. That, I believe, is the message in the current odd lot studies.

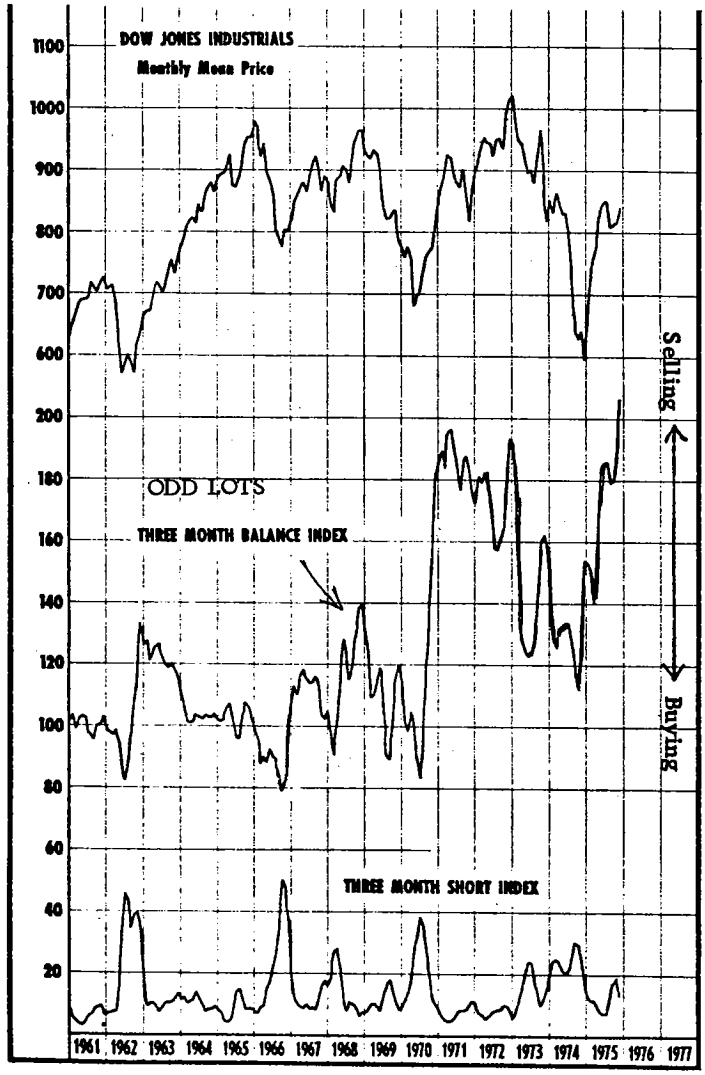
NEGATIVE VOLUME: Negative volume studies were presented in a number of recent Letters such as 638, 642, and 646. For the benefit of many new subscribers, I will review this study, particularly since the trend of negative volume (NV) could be about to say something different at this time.

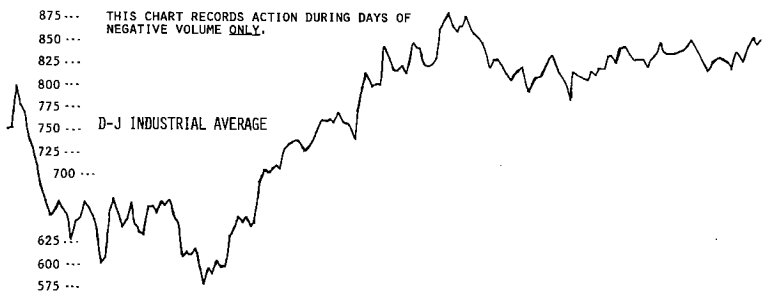
The concept of NV was discovered by the late Paul Dysart, one of the most brilliant of the pioneer market technicians. Dysart noted that "the public" tends to be active in high volume or exciting markets, whereas informed investors prefer to make their moves in quiet markets. This observation led to his theory of negative volume. The NV index is actually an A-D line based on advance-decline pluralities which are entered on any day when volume is below the preceding day. Thus, if volume today is 16 million shares on the NYSE and above yesterday's volume of 15 million shares, there is no entry on the NV index. But if tomorrow's volume drops to 14.5 million shares (below 16) we tabulate the A-D differential. If there were 400 advances and 600 declines, we enter the minus 200 on the NV index.

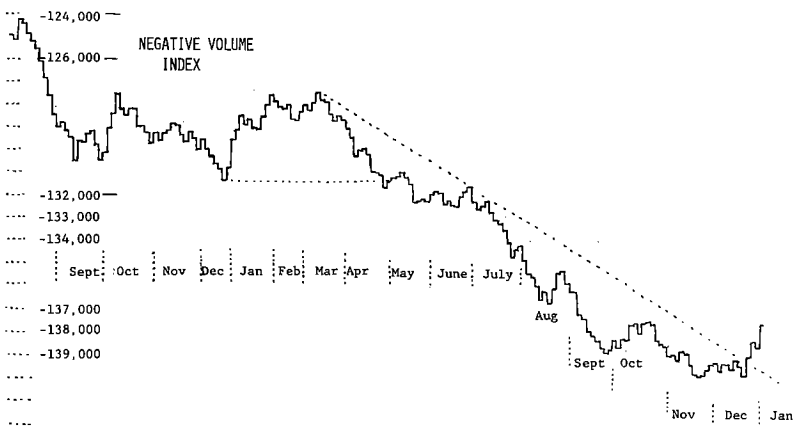
This A-D line based on contracting volume days, reasoned Dysart, shows us what is happening to informed money. It shows us the path they are following, based on the theory that they will be most active on the duller days. Personally, I consider the NV index one of the more important indices dealing with the "character" of the market. A market which produces a consistent trend of negative volume always bothers me, and if we study the accompanying chart it is at once evident that this market has been grinding out downside negative (with a few interruptions) since April, 1975.

The last few days of the year are always difficult to interpret, due to holidays, tax selling, cross-currents and generally lower volume. For whatever reason, however, the two days of December 24 and 26 produced a spurt in negative volume, a jump which succeeded in reversing the declining trendline which has been in effect since April. On January 2 another big jump in the advance-decline figures (on sharply lower volume) took the NV index just over its October peak. There is no question about it; this was the most hopeful indication from negative volume since the first quarter of 1975!

Note that the NV pushed to new highs during January and again in March of 1975. Then the NV index faded and refused to continue its support of the market. I am going to be very interested to see whether the current bullish indications in NV are going to persist — or whether this latest signal is fated to wash out like the signals of January and March, 1975. It has been a long time since we had a primary bull market suppor-

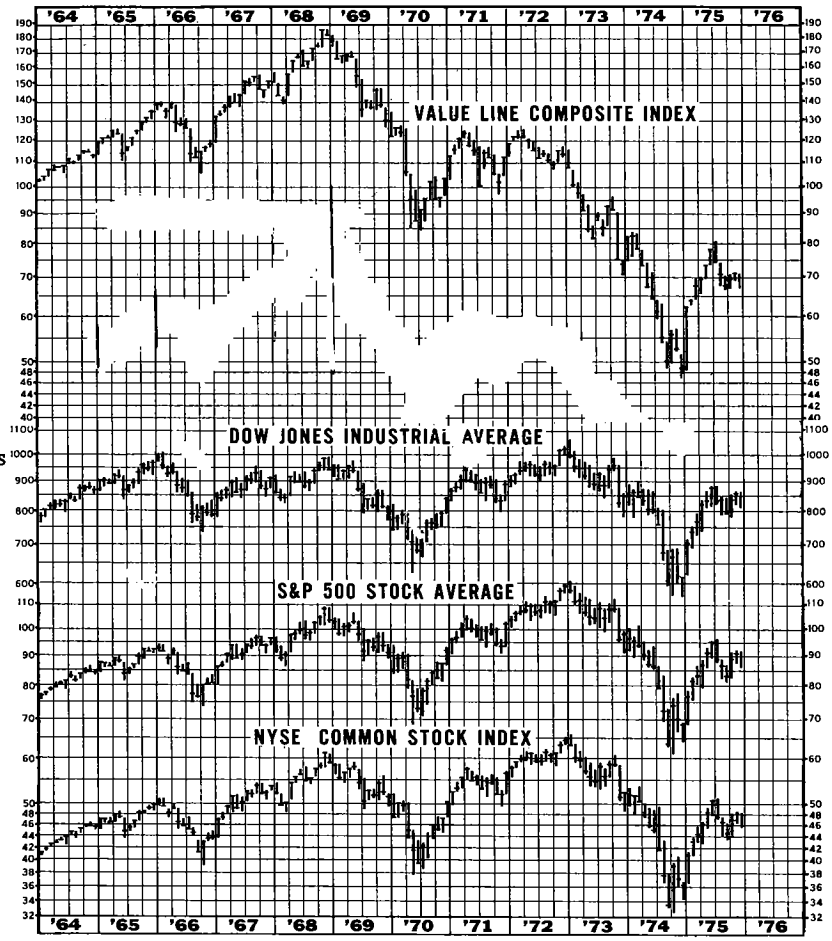






ted by NV. They are always the most profitable and most solid of bull markets. What NV does in the period ahead is going to weigh heavily on my thinking and feeling about this bull market.

PERSPECTIVE: As the New Year starts, I thought it would be worthwhile including this excellent ratio chart at right showing four widely-followed stock Averages and Indices (chart courtesy of Security Research, 108 Newbury St., Boston MA 02116). Here we see the Value Line Composite which is an unweighted index and is probably most representative of the average portfolio of diversified shares. At the bottom of the chart is the NYSE index which deals with the average change in percentages of all NYSE issues.

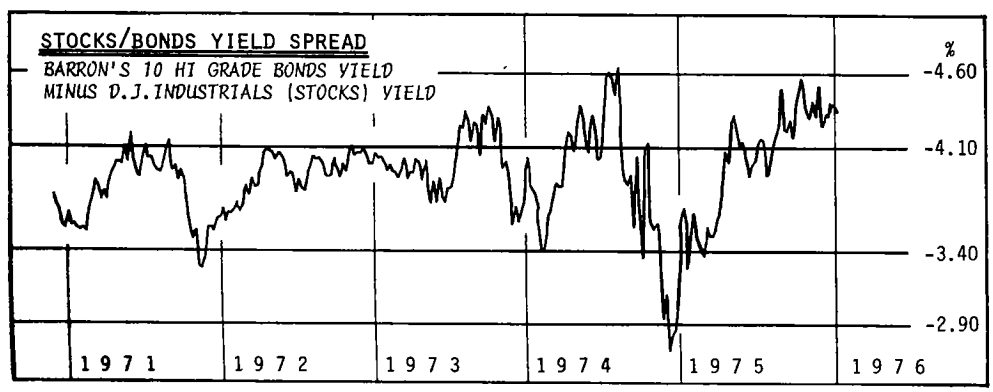

'64 '65 '66 '67 '68 '69 '70 '71 '72 '73 '74 '75 '76
VALUE LINE COMPOSITE INDEX
DOW JONES INDUSTRIAL AVERAGE
S&P 500 STOCK AVERAGE
NYSE COMMON STOCK INDEX

The Dow is the most popular of all Averages, and it is based on the average price of 30 industrial giants, constantly adjusted for stock splits and stock dividends Below the Dow is S & P's broad 500 Stock Average, an Average which is adjusted for stock capitalizations (so that the huge companies really move this index, while "peanut" companies have little effect on the 500).

What is so striking here is the fact that Value Line's Index shows that the average portfolio didn't rally as far as you might have thought during the big 1975 push. From the current level, the Value Line Index would have to almost double to take that index substantially above the half-way mark of the 1968-74 decline! Of course, the encouraging part of that observation is that it suggests that the average stock could have a long way to go on the upside before this bull market keels over (even if Value Line's Index is fated to recoup only half of its 1968-74 losses). On the monthly entries as depicted on the chart, the recent action of the market appears "toppy" on the Value Line Index.

The other three Averages do not differ from each other too drastically, but they do show that violent plunge of 1973-74, the powerful 1975 first-half return, and the hesitancy since July, 1975. It is well to remember that the first "snap-back" following a crash is always the easiest and most profitable part of a post-crash bull market (this was true in July-September, 1932, following the 1929-32 collapse). Then comes the period of digestion and evening-up, which I feel we are now experiencing. The next move on the upside will have to be based on the market's discounting of a solidly better environment for corporations and corporate profits. When the best minds (and money) satisfy themselves that "it's going to get better," and when they put their money where their thoughts are, we'll take off due North. That'll mean higher prices across the Board in an obvious, fundamental and technical primary bull sweep.

WHY A STRONG BOND MARKET IS "NEEDED": One of the most basic relationships in the world of investments is the relationship between stock and bond yields. Why is this so? Because the informed investor always has a choice before him — whether to buy stocks or whether to buy bonds.



For years the argument has been that stocks allow the investor to keep up with inflation while bonds represent a one-way ticket to capital attrition. And the argument held up remarkably well during the period of the 1950's and '60's. But two factors changed during the early 1970's. First, the stock market collapsed, resulting in massive losses in common stock portfolios. Second, bond yields rose to the highest levels in a hundred years.

 Thus, the man who purchases a Aaa-rated bond at a yield of over 8% may not be keeping up with inflation, but he does have an investment which will double in less than 9 years. A lower-rated bond having a yield of 10% will provide a doubling of capital in 7 years. When you consider that the average bank portfolio produced a rate of increase of about 1% per year over the past 10 years, high-yielding bonds are nothing to sneer at.

"But what about taxes?" you retort. "You can't show that kind of increase in bonds in the face of today's taxes." That is true, but remember, corporate profit-sharing and pension funds do not pay taxes until the money is paid out. They compound their money without paying taxes, and this huge segment of the investment world has to be watching the relationship between stock potentials and bond yields with great interest.

By way of illustration, I include this five-year chart of the stocks-bonds yield spread, and obviously when the indicator rises it shows yields in favor of bonds, when it declines it shows yields in favor of stocks. Currently, we are at the very high end of the scale in favor of bonds. Barron's 10-Hi Grade Bonds now yield 4.5% more than the yield on the 30 D-J Industrial issues. The only higher figure is the spike to 4.6% which appeared in mid-1974.

As I see it, one of two things must happen now if the stock market is to remain healthy. Either bonds must rally from here, thus reducing bond yields and bringing the stocks/bonds yield spread down. Or Dow dividends must be raised, thus producing the same effect (i.e., bringing the stocks/bonds yield spread down). The bonds/stocks yield chart is courtesy of Deliberations, PO Box 183 Adelaide St. Sta., Toronto, Ont, Canada M5C 2J1.

One other phenomenon is of particular interest to me at this time, in view of the stocks/bonds relationship. My daily chart of the 7-3/4 Treasury notes of 1981 shows that the T-notes are moving up into their third upward wave, each wave separated by a short correction. This pattern forms a classic A-B-C-D-E. Such configurations often complete an upward movement. If so, bonds could be in for a correction in the period ahead. Lower bond prices mean higher bond yields, and if this is the case, pressure will be put on stock prices.

Conclusion: At the current high level of the stocks-bonds yield spread, the stock market would be under real pressure if bonds declined and bond yields rally from here. Thus, I consider the stocks-bonds yield relationship of particular importance at this time.

STOCKS: As stated here over and over again, it is the consumer oriented groups that look best (on a relative strength basis) and are doing best. This includes such groups as electrical appliances, shoes, foods, drugs, textiles, and the electric utilities.

In the latter group, we have many preferred shares, and these are selling, in many cases, at levels which produce very fat yields. Many of the utility preferred's are cumulative, and this means that if they happen to skip a dividend that dividend is cumulated so that ultimately (if the profits are there) all back dividends are paid (before dividends are paid on the common shares, by the way). I consider the preferred shares of many of the medium to better quality utilities to be of outstanding interest here, and I will leave it to you and your broker to pick the actual companies. I would diversify, however, and I would take the numbers which yield 9% or more.

GOLD AND ANGOLA: With fighting going on around the borders of S. Africa, one would think that the price of bullion would be heading up with perhaps the price of the mines heading down. Instead, we have total "deadness" in both areas.

My own feeling is that the bear market in bullion may be "feeling" for a bottom, and the main danger in holding bullion from here on is that one may die of boredom. As for the shares, what I have said over the past year appears to be coming true. The S. African numbers do not look good to me. We don't know who is going to supply what, we don't know who is lying the most, but we do know one thing — arms are pouring into Southern Africa and particularly into Angola. They are Chinese arms, they are Cuban arms, they are US and Russian arms. The unbelievably difficult racial situation in S. Africa is not going to blow away, in my opinion. It's going to simmer and ultimately boil. It's going to boil because the whites are not going to give up what they consider to be theirs, and the blacks are now going to give up a continent which they consider their own.

The pressure to arm and rearm will continue strong in S. Africa. That will mean higher taxes and more S. African gold sales. These will be long-term depressants on gold shares and bullion, and in my opinion there is only one factor which will make gold an attractive hedge and speculation again. That factor is wild-fire inflation, a literal collapse of world currencies. Whether this is fated to occur in the late 1970's I do not know. If it does, there will be time to move into gold and perhaps gold shares (assuming they are a suitable investment at the time). At any rate, my policy on gold is about what it has been for the past few months. A few shares of Amgold and Homestake for those who are frothing to hold gold shares, but for the calmer heads, stand aside. I'm not excited about gold yet — not at all.

LATE NOTES (Jan. 5): The market closed today like a pistol with everything in gear on the upside. The Dow peak of 881.81 is now flashing like a beacon. If the Dow can better this July 14 level it will certainly be a bullish victory, even if the market declines very soon afterwards. On the other hand, if the Averages turn down with Industrials having failed to better 881.81 (closing basis), then we could have a much more difficult ball game. I don't like markets that run out of gas just under the old primary highs.

People are asking me why an Industrial rally through 881.81 is so important. This is a primary point in this bull market, a point that has not been bettered for six months. Often an Average will move up to a primary point, hesitate, back off, then push through it. We could get that kind of action now. But if we turn down under 881.81 we will have a fresh primary non-confirmation. That would not be good, as past history amply demonstrates.

Next mailing: January 16, 1976.